

Significant retirement savings legislation in South Korea

On 29 December 2004, South Korea passed a major piece of retirement savings legislation, which set out broad principles for the establishment and management of employer sponsored retirement plans. Although more detailed guidance is yet to be released, the Employee Retirement Security Act (ERSA) will provide employers with alternatives to the existing mandatory severance payment system.

Existing Korean system: severance payments

Currently, all employers (with five or more employees) must provide any employee leaving service with a severance payment of at least 30 days' average wages for each year of employment.

For most employees, such severance entitlements are a short to medium term savings arrangement, rather than a retirement plan. Moreover it is permissible for employers to cash out the accruing severance benefits annually to employees who remain in service. Although partial funding of the severance liabilities is possible via an insurance policy, most companies do not set aside external funds to meet their severance obligations.

The Korean government's policy is to evolve this system towards a mandatory, externally funded, retirement savings regime.

An overview of the ERSA

The ERSA allows employers to continue to provide severance payments as described above. Alternatively, the ERSA now provides employers with the option of establishing:

- A defined benefit (DB) plan. This must provide a final salary linked benefit equal in value at retirement to at least one month's final salary for every year of service, or
- A defined contribution (DC) plan. The employer must contribute at least 1/12th of annual salary, which would be accumulated with investment earnings until date of payment. Investment options and the ability to make voluntary contributions must be provided to the employee.

These new options available to employers must be externally funded. The legislation describes a framework for insurers and other financial institutions to provide administration and investment services to such retirement plans.

The ERSA sets out broad set of principles and obligations covering member reporting standards, the involvement of employee representatives, the need for employee education, and solvency requirements for DB plans. The Ministry of Labour is assigned as principal regulator, and will establish a "Retirement Pension Review Committee" to make decisions on future amendments to the legislation.

The legislation also introduces a new retail retirement product called an Individual Retirement Account (IRA). IRAs are primarily intended for employees who choose to invest their severance payments in a retirement plan. Additionally, employers with less than 10 employees may contribute to their employees' IRAs in lieu of providing their own plan.

The new options of DB or DC plans as an alternative to severance pay benefits takes effect from 1 December 2005. Employers with less than 5 employees (who are currently exempt from the requirement to provide severance pay) will become subject to the retirement benefits legislation by 2010 at the latest.

Details still to follow

ERSA does not describe what, if any, tax incentives will be used to encourage employers to introduce funded DB or DC plans. It is similarly unclear whether any changes will be made to the tax treatment of existing severance pay plans.

Presidential Decrees are expected in the coming months to fill in the details, including the:

- mechanism for providing employee representation,
- obligations on pension providers
- investment restrictions,
- requirements for employee education, and
- circumstances DB and DC plan members will be able to access their funds prior to retirement (for example house purchase).

Further developments

Korea has joined the global trend towards pension reform. However, the legislation does not currently oblige employers to move from their existing severance payment arrangements to the DB or DC plans. Therefore, the reaction of employers will depend on the following critical factors:

- The tax incentives for employees and employers of the new options relative to the existing severance pay system.
- The level of competition and emerging product quality in the marketplace for pension products.
- The comparative design options for DB and DC relative to the severance pay benefits, in particular the restrictions on cashing out benefits prior to retirement.

As noted above, further detail is still to emerge. Watson Wyatt will continue to monitor these developments and will provide further updates as the Presidential Decrees are released.

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